Internal Revenue Service

memorandum

CC:TL-N-8120-88
Br4:JRDomike

date: AUG 12 1988

to: District Counsel, Louisville CC:LOU

from: Director, Tax Litigation Division CC:TL

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subject: [redacted]

This responds to your request for technical advice on questions which arose in connection with your review of a proposed notice of deficiency. The notice of deficiency must be issued before September 15, 1988.

ISSUES

1. Whether the taxpayer is entitled to a charitable contribution deduction pursuant to I.R.C. § 170(e)(3) for the donation of inventory property to a tax exempt association which in turn distributes the property to its member organizations.

2. If the taxpayer is entitled to a charitable contribution deduction under I.R.C. § 170(e)(3), is the amount of the deduction determined on an item-by-item basis or by aggregating the bases and fair market values of all the contributed items before applying the statutory limitations to determine the amount of the deduction.

CONCLUSION

1. We agree with you that it is inadvisable for the Service to make a determination in the proposed notice of deficiency that the taxpayer is not entitled to any charitable contribution deduction for the donation of the inventory property in this case.

2. We agree with you that the position taken by the revenue agent that the amount deductible for the donation of inventory property should be computed item-by-item appears to be correct.

FACTS

The facts stated in your memorandum are incorporated herein by reference. Briefly:

The taxpayer is a corporation engaged in manufacturing hardware. It contributed inventory to [redacted] ([redacted]), a 501(c)(3) organization. The contributed inventory included [redacted], and [redacted]. The examining agent questions whether these items were being used by the donee solely for the care of the ill, the needy, or infants as required by I.R.C. § 170(e)(3)(A)(i). The donee in this case acts as a clearinghouse for donated inventory which it passes on to its members, some [redacted] that are also exempt from income tax under section 501(c)(3). IRS conducted a collateral examination of [redacted], but has not revoked its exemption and has determined that it continued to qualify for exemption.

[redacted] furnished to the taxpayer a written statement that describes the contributed property and represents (1) that the use of the property will comply with the requirements of the Code and regulations, (2) that the donee organization meets the requirements of the Code and regulations, and (3) that the organization will maintain adequate books and records and make them available to the Service upon request, pursuant to Treas. Reg. § 1.170A-4A(b)(4).

In computing its charitable contribution deduction, [redacted] totalled the bases and the fair market values of all the items donated and applied to these totals the formula under I.R.C. § 170(c)(3)(B). The examining agent has taken the position that the amount deductible should be determined item by item.

DISCUSSION

Section 170 of the Internal Revenue Code allows a deduction for any charitable contribution payment of which is made within the taxable year. I.R.C. § 170(a)(1). Section 170(e) limits the deduction for certain contributions of appreciated property. Section 170(e)(1)(A) generally reduces the amount of any charitable contribution of property by the amount of gain which would not have been long-term capital gain if the property had been sold by the taxpayer at its fair market value (determined at the time of the contribution), thus limiting the

deduction herein to basis (cost of goods "sold"). Section 170(e)(3), however, allows a limited deduction in addition to basis for certain corporation "qualified" contributions of inventory and other property. See Treas. Reg. § 1.170A-4A. 1/

A qualified contribution of such property must meet four requirements:

(i) The use of the property by the donee must be related to the purpose or function constituting the basis for its exemption, and the property must be used by the donee solely for the care of the ill, the needy, or infants;

(ii) The property may not be transferred by the donee in exchange for money, other property, or services;

(iii) The taxpayer must receive from the donee a written statement representing that its use and disposition of the property will be in accordance with the provisions of (i) and (ii); and

(iv) In the case where the property is subject to regulation under the Federal Food, Drug, and Cosmetic Act such property must fully satisfy those requirements. I.R.C. § 170(c)(3)(A).

To effect the allowable deduction, section 170(c)(3)(B) limits the section 170(e)(1)(A) reduction to the sum of (i) one-half of the section 170(e)(1)(A) gain plus (ii) the amount (if any) by which the basis together with one-half of the gain exceeds twice the basis of such property. In other words, the deduction for contributed inventory is limited to the lesser of (1) basis plus one-half unrealized gain or (2) twice basis. Treas. Reg. § 1.170A-4A(c); Rev. Rul. 85-8, 1985-1 C.B. 59.

1/ Section 170(e)(3) was added to the Code by section 2135(a) of Public Law 94-455 (Tax Reform Act of 1976), October 4, 1976; paragraph (A) was amended by section 5(a)(21)(A) of Public Law 97-354, October 19, 1982. Sen. Rep. No. 94-938, Part 2, 94th Cong. 2d Sess. 78 (1976), reprinted at 1976-3 (vol. 3) C.B. 643, 720-721; Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976 672 (1976), reprinted at 1976-3 (vol. 2) C.B. 1, 684.

Issue 1--Application of I.R.C. § 170(e)(3)(A)

In this case the examining agent questioned whether the taxpayer met the requirement in paragraph (i) of section 170(e)(3)(A), that the property must be used by the donee solely for the care of the ill, the needy, or infants.

We agree with the discussion of this issue in your memorandum, and incorporate it herein by reference. The facts in this case could not support defense of a determination that this contribution of hardware is not properly used by the donee solely for the care of the ill, the needy or infants.

Although the inventory--hardware--is different from the types of inventory--food, clothing, medical equipment, and supplies--alluded to in the legislative history and the regulations, there is no limit in the statute on the type of inventory that may qualify. See Treas. Reg. § 1.170A-4A(b)(1). In a private letter ruling, PLR 8420036, a contribution of photocopying machines was held to qualify under section 170(e)(3)(A). In this case, there may be a need among the [redacted] members of [redacted] for [redacted], large numbers of [redacted].

Furthermore, the taxpayer appears to be justified in relying upon the written statements received from the donee, as is held in TAM 8737002. See Treas. Reg. § 1.170A-4A(b)(2) and (4). Additional support for that reliance is the result of the Service's collateral examination of [redacted] wherein the Service did not revoke its exemption.

All in all, this appears to be a case for Counsel to recommend to the District Director against issuing the proposed determination in the notice of deficiency, because of the inadequacy of evidence to sustain it. CCDM (35)230(2).

Issue 2--Application of I.R.C. § 170(e)(3)(B)

As you note in your memorandum, the formulation for the total deduction allowable under section 170 for a contribution of inventory property pursuant to section 170(e)(3) is the lesser of (1) basis plus one-half unrealized gain or (2) twice basis of the property. Treas. Reg. § 1.170A-4A(c).

In this case, the taxpayer has chosen to aggregate all the bases and aggregate all the potential gains prior to applying the formula. Your illustration of the method is reproduced below:

Item	(a) FMV	(b) Basis	(c) Basis and 1/2 gain	(d) Two x basis	Amount allowable (lesser of c or d)
1.	$ 1,000.00	$ 100.00	$ 550.00	$ 200.00	$ 200.00
2.	100.00	80.00	90.00	160.00	90.00
3.	100.00	40.00	70.00	80.00	70.00
4.	500.00	450.00	475.00	900.00	475.00
5.	12,000.00	1,200.00	6,600.00	2,400.00	2,400.00
			Total allowable item-by-item		$3,235.00
Aggregate:					
	$ 13,700.00	$ 1,870.00	$ 7,785.00	$ 3,740.00	$3,740.00

Difference between item-by-item and aggregate methods= $ 505.00

The illustration also shows the amount of deduction computed item-by-item by the method proposed in the notice of deficiency.

We agree with the examining agent that the item-by-item method is correct.

Aggregation will always result either in the same total amount allowable 2/ or a larger allowable than itemization. When aggregation produces a larger allowable it is because aggregation increases the allowable of a particular item from "the lesser of [basis plus 1/2 gain] or [twice basis]" to "the greater of [basis plus 1/2 gain] or [twice basis]". This is contrary to the rule of section 170(e)(3)(B), which limits the deduction for "any qualified contribution" (emphasis added) to the lesser. You have shown this in your example reproduced above.

The difference of $505.00 in your example is the aggregate of the differences between the "(d)" column and the "(c)" column for three items (2, 3, and 4) where the "(c)" amount in each case is less than the "(d)" amount. Without taxpayer's aggregation, the allowable amount for items 2, 3, and 4 would be the lesser of "(c)" or "(d)". Taxpayer's aggregation would permit the allowable amount for items 2, 3, and 4 to be the greater of "(c)" or "(d)", contrary to the rule.

2/ Whenever all of the items are limited by "(c)" (basis plus 1/2 gain) the aggregate will be the same as the itemized allowables; similarly, when all are limited by "(d)", (twice basis). However, in a business where some items would be limited by "(c)" and some by "(d)", aggregation produces the larger allowable.

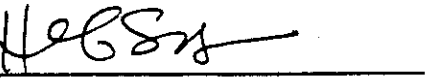
If in your example item 5 were changed to $10,000 basis, "(c)" amount $11,000, "(d)" amount $20,000 and then allowable $11,000, the aggregate allowable would be the total of column "(c)" or $12,185, but the itemized allowables would total $11,835. The difference, $350, is in item 1; aggregation would allow item 1 the greater deduction of "(c)" or "(d)", that is $550 instead of $200, contrary to the rule.

This explains why aggregation is not permitted: it breaks the rule for the particular item that is allowed the greater of [basis plus 1/2 gain] or [twice basis], rather than the lesser.

This explanation is consistent with the definition of "qualified contribution." As noted above, section 170(c)(3)(B) limits the deduction for any qualified contribution to the lesser of [basis plus 1/2 gain] or [twice basis]. A qualified contribution means a charitable contribution of property only if the property passes the four tests of section 170(c)(3)(A). The four tests of (A) must be applied to each item of property, otherwise an entire contribution of multiple items would be disqualified if one item failed any test and aggregation applied. Similarly the amount of reduction in (B) must be applied to each item, because the words "such property" in section 170(e)(3)(B) must mean "item of property" as it does in (A).

This is an issue of first impression. It is not dealt with in the examples in section 1.170A-4A of the regulations or Rev. Rul. 85-8, 1985-1 C.B. 59. We agree with you that it is appropriate to raise this computation issue in the statutory notice of deficiency.

MARLENE GROSS
Director

By: 

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